

**TAX EXPENDITURES: CURRENT ISSUES  
AND FIVE-YEAR BUDGET PROJECTIONS  
FOR FISCAL YEARS 1982-1986**

**The Congress of the United States  
Congressional Budget Office**



ERRATUM

TAX EXPENDITURES: CURRENT ISSUES  
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Page 72: Table 7 should include the capital cost recovery provisions of the Economic Recovery Tax Act of 1981 under "Increases in Tax Expenditures." These provisions will reduce revenues by \$1,503 million in 1981, \$9,569 million in 1982, \$16,796 million in 1983, \$26,250 million in 1984, \$37,285 million in 1985, and \$52,797 million in 1986.



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## PREFACE

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The Congressional Budget Office is required by section 308(c) of the Congressional Budget Act of 1974 to issue a report each year that projects tax expenditures for each of the next five fiscal years. This report fulfills that statutory requirement for fiscal years 1982 to 1986. It is a companion to Baseline Budget Projections: Fiscal Years 1982-1986 (July 1981), which gives CBO's projections of budget authority, outlays, and revenues for the same period.

This report also discusses a number of definitional and measurement issues that have arisen with respect to tax expenditures, and reviews some of the economic, jurisdictional, budgetary, and administrative considerations in choosing among tax expenditure subsidies, general tax cuts, and direct expenditure subsidies. It also reviews briefly the legislation affecting tax expenditures enacted in calendar years 1980 and 1981, including the Economic Recovery Tax Act of 1981. The five-year projections of revenue losses from tax expenditures in Appendix A do not include the effects of that act, however; they reflect the law in effect on January 1, 1981.

The report was prepared by James M. Verdier of the Tax Analysis Division, with assistance from Ralph Rector, Willie Bradford, and Martha Campbell. All members of the Tax Analysis Division provided valuable comments and suggestions. A number of others both inside and outside of the CBO made detailed comments on earlier drafts, including Henry Aaron, Albert Buckberg, Sheldon S. Cohen, Seymour Fiekowsky, Alfred B. Fitt, Jerome Kurtz, Paul R. McDaniel, Joseph A. Pechman, Allen Schick, Mark Steitz, Emil M. Sunley, Stanley S. Surrey, and Paul Van de Water. Patricia H. Johnston edited the manuscript, and Linda Brockman typed it.

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## SUMMARY

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Tax expenditures are revenue losses that result from provisions of the federal tax code that give special or selective tax relief to certain groups of taxpayers. Like federal spending and loan programs, tax expenditures serve to channel resources from some sectors of the economy to others. The investment tax credit, for example, encourages investment in business plant and equipment by allowing those who make such investments to pay less tax than they otherwise would, while the extra personal exemption for the blind gives special tax relief to this class of taxpayers.

There is occasional uncertainty about whether a particular provision should be treated as a tax expenditure or not. The general rule is that provisions that are part of the normal structure of the income tax--general rate schedules and exemption levels, deductions for the costs of earning taxable income, and the like--are not tax expenditures; only special provisions that have some purpose beyond simply defining taxable net income fall into this category.

## MEASUREMENT

Since tax expenditures represent revenue the federal government does not collect, measuring them presents some special conceptual and practical problems. The amount of revenue that would be collected under some different law can never be directly observed. A tax system without tax expenditures is simply an abstraction; it cannot be measured with the same precision that actual outlays and tax collections can.

In addition to this conceptual problem, practical difficulties arise because of the interaction of the revenue loss estimates of tax expenditures with the standard deduction (zero bracket amount), marginal tax rates, and other provisions of the tax code. The estimates for each tax expenditure are made by assuming that the provision is repealed, that all other provisions of the tax code are unchanged, and that economic behavior is not affected by the tax expenditure change. While this is a convenient and useful approach for estimating the cost of a single tax expenditure, since

it corresponds roughly to the estimates for individual spending programs, it becomes less realistic as more and more simultaneous changes in tax expenditures are included in the estimate. The arithmetic total of all tax expenditure revenue losses thus has only limited value. Nonetheless, the estimates of the revenue loss from each individual tax expenditure serve well the major purpose of the tax expenditure budget, which is to compare the costs and benefits of alternative ways of channeling resources to particular groups or activities.

#### TAX EXPENDITURE SUBSIDIES, GENERAL TAX CUTS, AND DIRECT EXPENDITURE SUBSIDIES

Since the effects of tax expenditures are very similar to those of federal spending and loan programs, it is useful analytically to consider tax expenditures as alternatives to spending programs. In practice, however, the choice is frequently between changes in tax expenditures and more general tax cuts. Changes in tax expenditures are normally considered in the context of tax legislation, and committee jurisdictional constraints generally limit the extent to which trade-offs between tax expenditures and direct spending programs can be made. Trade-offs between tax expenditures and general tax cuts are more feasible. The size of a general tax cut may be reduced to make room for new or increased tax expenditures, while revenue raised from reducing existing tax expenditures can be used to finance a larger general tax cut.

#### Tax Expenditures Versus General Tax Cuts

In deciding between tax expenditures and general tax cuts, the choice is generally between relatively large per-taxpayer savings for a narrowly defined group of taxpayers and relatively small per-taxpayer savings for large numbers of taxpayers. More specifically, the choice may turn on the possible effects of alternatives on taxpayer behavior and marginal tax rates.

Proponents of tax expenditures that encourage or reward a certain kind of behavior--targeted savings incentives, for example--frequently argue that such provisions will have greater effects on taxpayer behavior than broad across-the-board tax cuts of the same overall dollar amount. While tax subsidies or incentives that favor a particular kind of economic activity will result in more resources being devoted to that activity, this usually represents a reallocation of existing resources rather than any

overall increase in resources. The effects on overall economic activity are likely to be about the same as from a general tax cut of the same size.

Tax expenditures can be viewed as both a cause and an effect of high marginal tax rates. Because tax expenditures remove a large share of income from the tax base, tax rates must be higher on the taxable income that is left to raise the same amount of revenue. And because marginal tax rates often reach quite high levels, there is continual pressure for tax expenditures to shield income from those high rates.

#### Tax Expenditures Versus Direct Expenditures

Tax subsidies can also serve as alternatives to spending or loan programs. Almost any feature that is included in a spending or loan program can be duplicated in a tax subsidy. There are some practical differences between tax and direct expenditure subsidies, however, that may lead the Congress to choose one rather than another.

Nontaxpayers. It can be difficult to extend tax subsidies to individuals and businesses that do not pay taxes. The most straightforward way of doing so is through the use of "refundable" tax credits--credits that are paid directly in cash to the recipients if they do not have tax liability as large as the credit. The only tax expenditure that is currently refundable is the earned income credit for low-income workers with dependents, but it has frequently been suggested that the investment tax credit and other business tax credits be refundable as well. Another way of extending tax subsidies to nontaxpaying businesses is through leasing arrangements, whereby a business with little or no tax liability leases equipment from a business with enough taxes to use the subsidy. The rules for this arrangement were considerably liberalized in the Economic Recovery Tax Act of 1981.

Experience with the earned income credit suggests that nontaxpaying individuals, especially those with low incomes, can be more difficult to deal with through the tax system than nontaxpaying businesses. The IRS may have no record of the existence of nontaxpaying individuals, and thus cannot easily inform them of their possible eligibility. Many low-income individuals are fearful of the IRS, and may be reluctant to have any association with it. Even if they overcome their reluctance, they may have difficulty with the forms and paperwork necessary to establish their

eligibility, and the IRS has relatively few resources to provide them with assistance.

Committee Jurisdictions. Tax expenditures come under the jurisdiction of the tax-writing committees, while most spending programs that might be considered as alternatives come under the jurisdiction of other committees. Although this can make it difficult for the Congress to consider directly trade-offs between tax subsidies and spending programs, the problem can be eased by provisions in both Houses for the joint referral of legislation to two or more committees.

The tax committees sometimes lack expertise in program areas in which tax subsidies are provided. These committees do have jurisdiction over a wide range of health, welfare, Social Security, and unemployment compensation programs, however, and have dealt extensively in recent years with energy issues. Joint referral can also help to make up for a lack of tax committee expertise.

Budgetary Control. Tax expenditures are subject to less precise control in the budget process than are most spending programs. The budget resolutions do not set targets for tax expenditures by budget functional categories, as they do for direct spending programs. Nor are the tax committees allocated target ceilings for tax expenditures, as all committees are in the case of spending programs under their jurisdiction.

Revenue floors -- The budget process does impose one very important constraint on tax expenditures, however. Once an overall revenue floor is established by the second budget resolution, any legislation that would reduce total revenues below the floor is subject to a point of order. This requires that any increases in tax expenditures compete with all other revenue-losing provisions for the limited amount of tax reduction that is permitted. This is not very different from the discipline that applies to spending programs. While the second budget resolution does include limits on spending by major functional category, it is only the overall spending totals that are binding, just as it is only the overall revenue floor that limits tax expenditures.

Visibility -- Each bill increasing or reducing tax expenditures is accompanied by a report giving an estimate of the five-year loss or gain from the change, just as spending bills are accompanied by five-year cost estimates. Changes in tax expenditures have the same effect on the federal deficit as do any other



tax or spending changes, and thus receive whatever attention and scrutiny that entails.

Periodic review -- Tax subsidies are not regularly reviewed in the way that spending programs subject to annual appropriations or periodic reauthorizations are. With the growth in recent years of entitlement programs, however, only about half of federal spending is subject to discretionary annual appropriations, and programs that are periodically reauthorized may not receive detailed scrutiny each time. In addition, tax expenditures often come up for review when the Congress considers major tax legislation, which it has done often over the last decade. Some new tax expenditures in recent years have also included scheduled expiration dates and/or required studies of their effectiveness, thereby encouraging periodic review.

### Administration

The ease of administration of any subsidy program depends mainly on the eligibility rules and how they are enforced. If the rules are clear and simple, if the information needed to verify eligibility can be easily obtained, and if no significant exercise of judgment is required to apply the rules, administration of the subsidy is easy. The more a program departs from these conditions, the harder it is to administer. Tax subsidies are not different from other subsidies in this respect.

For programs that fall into the easy-to-administer category, there are some advantages in using the IRS as a subsidy distribution mechanism. It is a well-run bureaucracy that deals annually with nearly 100 million taxpayers. It already has much of the information on income, family size, and other characteristics that may be used to determine eligibility, and it can make spot checks through its system of audits.

Only about 2 percent of returns are audited, however, and many subsidy programs have eligibility rules that rely on information that tax auditors rarely check. If, therefore, the Congress wants to keep fairly close watch on eligibility for a subsidy program, providing the subsidy through the tax system may not be the best approach. But if the Congress determines that the costs of detailed eligibility checks for a particular program are likely to be greater than the losses from payments to ineligible recipients, the tax system may be preferable to setting up a new or expanded bureaucracy to administer a direct spending subsidy.

A major drawback to using the IRS as a subsidy distribution agency is that it can impose a significant burden of extra complexity on both taxpayers and the IRS. With IRS resources already severely strained by frequent changes in tax legislation, expanding tax shelter activities, and apparently widespread tax evasion in the so-called "underground economy," the extra burden of running multiple subsidy programs could lead to administrative breakdowns.

Another consideration in having the IRS administer a subsidy program is that the IRS is not likely to be as sympathetic to the goals of the program as an agency with jurisdiction over analogous direct spending programs might be. When the IRS is assigned the task of administering subsidies for housing, employment, home insulation, preservation of historic buildings, local economic development, and the like, the usual response is to treat the subsidies as if they were normal tax provisions rather than subsidy programs. Eligibility is restricted as narrowly as possible, consistent with the provisions of the statute, in order to minimize the loss of revenue. Little attempt is made to publicize the availability of the subsidy or to promote its use. Attempts to overcome these problems by having tax subsidies jointly administered by the IRS and the agencies responsible for comparable spending programs are often bogged down by interagency conflicts over eligibility rules and administrative procedures.

#### Beneficiary Perceptions and Preferences

The beneficiaries of a tax subsidy usually prefer not to think of the tax savings they receive as a subsidy, but rather as something that results from a normal feature of the tax code. If there is likely to be substantial reluctance to take advantage of a subsidy--as seems to be the case with the present targeted jobs tax credit--having it work as much like a normal provision of the tax code as possible could encourage more widespread use.

Beneficiaries may also prefer receiving subsidies through the tax code because they may believe that the subsidies will be more stable and predictable than direct spending subsidies. While it is generally true that tax subsidies are less subject to changes, cutbacks, and delays in funding than federal spending programs, they are not immune from this kind of unpredictability. The legislative and administrative rules for various tax shelter and tax-exempt bond subsidies, for example, have been continually changed and tightened in recent years.

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## CHAPTER I. INTRODUCTION

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### DEFINITION

Tax expenditures are revenue losses that arise from provisions of the tax code that give special or selective tax relief to certain groups of taxpayers. They are defined in the Budget Act as:

. . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.<sup>1</sup>

There are certain features in an income tax that are an integral part of the normal structure of the tax, including general rate schedules and exemption levels, general rules on who is subject to tax and what accounting periods should be used, and deductions for the costs of earning taxable income. These normal features of an income tax are not considered tax expenditures. Only special provisions of the tax code that have some purpose beyond simply defining taxable net income fall into this category.

These special provisions are usually designed to encourage some desired activity or to provide aid to certain categories of taxpayers and are, thus, similar to many federal spending and loan programs. The investment tax credit, for example, is intended to encourage investment in business machinery and equipment, while the extra personal exemption for the blind gives special tax relief to these handicapped taxpayers.

There are sometimes difficulties in distinguishing between tax expenditures and provisions that are part of the normal structure of the tax code. The just-enacted deduction for two-earner married couples, for example, is treated as a tax expenditure. But if the Congress had adopted a broader approach and allowed married couples to be taxed separately at the lower rates applicable to single

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1. The Congressional Budget Act of 1974, Sec. 3(a)(3)).

persons, the change would probably have been regarded as a modification of the basic tax structure rather than as a tax expenditure. While there are always borderline definitional issues, there has been general Congressional and Executive branch agreement over the years on which provisions of the tax code are "special" enough to be termed tax expenditures.

#### VARIOUS INTERPRETATIONS

The identification of a provision of the tax code as a tax expenditure does not imply a judgment about the merits of the provision. Tax expenditures are simply one of the ways in which the federal government seeks to allocate resources or influence behavior in the private sector. Just as with federal spending or loan programs, evaluation of the provision depends on the purposes being served and the cost and effectiveness of the provision compared to other ways of promoting the same objective.

Nonetheless, listing the revenue losses from special-purpose provisions of the tax code in a "tax expenditure budget" has been viewed by many as a way of identifying "tax loopholes" that are ripe for abolition or reform. Many of the items in the tax expenditure budget are, in fact, cited frequently as potential revenue-raising tax reforms, but there are others that few would want to disturb and many want to expand.

Some have objected to the whole concept of tax expenditures on the ground that it implies that the federal government is entitled to 100 percent of everyone's income, and that any portion of it taxpayers are allowed to keep is theirs only by special sufferance. The base against which tax expenditures are measured is not all income, however; it is the amount of tax that would be collected by a normal tax system that allowed no special exceptions for nontax purposes. Tax expenditures are departures from the normal tax structure, which falls far short of taxing one hundred percent of all income.

It is frequently stated or implied in analyses of particular tax expenditures that a differently structured spending program would be better than the tax expenditure on equity, efficiency, or other grounds. The alternative to a tax expenditure need not be a spending program, however. The revenue gained from eliminating a tax expenditure might well be used to reduce the federal deficit or returned to taxpayers in the form of a more general tax cut.

Converting a tax expenditure into a more general tax cut is one way of reducing federal influence over the private sector. Instead of providing a tax saving only to those in special circumstances, or who arrange their affairs in special ways, tax savings could be extended more broadly, with no strings attached. This would give taxpayers greater freedom to decide for themselves how to use their money, with less attempt by the federal government to guide their decisions.

#### ALTERNATIVE TERMS

Tax expenditures are not exactly the same as direct expenditures in all respects. As the next chapter points out, measuring the cost of tax expenditures for budgetary purposes presents problems that do not arise for most spending programs. In addition, tax expenditures that involve a deferral of tax liability are more like loan programs than direct grant programs. There is also concern that the term "tax expenditure" has acquired an unduly negative connotation.

A variety of alternative terms has thus been suggested: tax incentive, tax advantage, tax benefit, tax concession, tax relief, tax subsidy, and so on. There is probably little to be gained by seeking a consensus on nomenclature. This report frequently uses the term "tax subsidy," but other synonyms may creep in from time to time.

#### OUTLINE OF THE REPORT

Chapter II describes some of the problems and issues involved in measuring tax expenditures and accounting for them in a way that is similar in budgetary terms to the treatment of spending programs. Chapter III analyzes some of the jurisdictional, budgetary, and administrative considerations in choosing among tax subsidies, direct expenditure subsidies, and general tax cuts. Chapter IV describes the new changes in tax expenditures enacted in 1980 and 1981, including those in the Economic Recovery Tax Act of 1981. The fiscal year 1982-1986 projections of tax expenditure revenue losses appears in Appendix A. These projections reflect the law in effect on January 1, 1981. Finally, there is an appendix listing tax expenditures under the committees that have jurisdiction over analogous direct expenditure programs.

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## CHAPTER II. MEASUREMENT OF TAX EXPENDITURES

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Conceptually, tax expenditures are revenue the federal government does not collect, so measuring them presents some special practical problems. The amount of revenue the government has collected under existing law can be directly observed; so can the amount being spent. But the amount of revenue that would be collected under some different law must be estimated; it can never be directly observed. (The future effects of tax laws and spending programs must also be estimated, of course, but ultimately there are actual tax collections and outlays against which to test the estimates.) A tax system without tax expenditures is simply an abstraction; it exists in the mind, and can never be measured with the same precision that actual outlays and tax collections can.

Tax expenditure estimates are based on samples of tax returns from past years and other economic and demographic data. The specific techniques used to measure the different types of tax expenditures are as follows:

- o Tax Credits. The amount of the expenditure is equal to the amount of the credits claimed by taxpayers.
- o Preferential Rates. The expenditure is calculated by multiplying the amount of income to which the special rate is applied by the difference between the regular tax rate and the preferential tax rate.
- o Special Exclusions and Deductions. The expenditure is calculated by adding the amount excluded or deducted from taxable income back into the taxpayer's income, and then computing a new tax liability on that income; the tax expenditure is equal to the difference between the hypothetical tax liability so computed and the liability incurred under current law.<sup>1</sup>

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1. In some cases, removal of a particular provision would reduce the total of a person's itemized deductions beneath the stan-

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- o Deferrals of Liability. The expenditure is calculated as the difference between taxes paid under current law and those that would have been paid had the deferral never been allowed.

The revenue loss from each tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the provision had never existed, but both taxpayer behavior and all other tax provisions remained the same as they are under current law. This is not an estimate of the amount of revenue that would be gained if the provision were repealed, since repeal of the provision would likely change taxpayer behavior in ways that would generally reduce the revenue gain. It is also not an estimate of the revenue that would be gained if two or more tax expenditures were repealed simultaneously, since interactions among different tax expenditures and other tax provisions could make the revenue gain either more or less than if the tax expenditures were repealed separately.

Tax expenditures are similar in these respects to direct outlay programs in the federal budget. The outlay figures for a particular program do not represent the amount by which the deficit would be reduced if the program were eliminated, since elimination would usually lead to partly offsetting cost increases in other programs and reductions in tax receipts. Similarly, the budgetary saving from abolishing two spending programs simultaneously might not be the same as the sum of the saving from eliminating each separately.

In the case of both outlays and tax expenditures, the budgetary cost should be considered separately from the net effect on the federal deficit or surplus if the provision was eliminated. The net effect from elimination is almost always less than the direct cost, since all tax and spending changes have "reflow" or "feedback" effects that partially offset the direct effects of the change. Tax cuts, for example, may stimulate economic activity, which reduces some federal spending and increases tax collections, thereby offsetting some of the initial budgetary effects of the tax

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dard deduction or zero bracket amount, and the person would no longer itemize. In those cases, the tax expenditure is figured by taking the excess of his total itemized deductions over the zero bracket amount and multiplying that excess by the appropriate marginal rate.



cut. Spending cuts may reduce economic activity, leading to partially offsetting federal spending increases and reductions in tax collections.

Because the estimates of individual tax expenditures are generally consistent methodologically with those of individual spending programs, subsidies of both kinds can readily be compared. A further refinement, discussed below under "outlay equivalents," would make this comparison even more precise. The tax expenditure budget thus highlights some of the possible choices and trade-offs in allocating scarce resources. By accounting for the federal resources devoted to specific purposes through the tax code, it permits consideration of alternative uses of those resources for other purposes, or for the same purposes through a different mechanism. In 1981, for example, the Congress had a number of options for dealing with the \$200/400 interest and dividend exclusion. The provision could have been continued at its existing level, or the \$3 billion in revenue that it cost each year could have been used to finance a 1 percentage point across-the-board reduction in tax rates, an expansion of Individual Retirement Accounts (IRAs) and Keogh plans, direct federal assistance for the savings and loan industry, a reduction in the federal deficit, or increases in other spending programs. In the end, the Congress decided to eliminate the interest exclusion after 1981, and use the savings to fund a temporary new program of one-year \$1,000 tax-exempt savings certificates, to be followed in 1985 by a new 15 percent net interest exclusion for the first \$3000 of net interest.

#### LIMITATIONS OF TAX EXPENDITURE ESTIMATES

##### Arithmetic Totals

While the estimates of individual tax expenditures permit useful comparisons with the outlays for similar programs, the arithmetic total of all the tax expenditure estimates has significant limitations. As was noted earlier, the cost of each tax expenditure is estimated by determining how much additional revenue would be collected if the provision did not exist. This presents some special problems when more than one tax expenditure is involved. If three or four tax expenditures that take the form of personal deductions did not exist, for example, more people would use the standard deduction (zero bracket amount), and the net cost would be less than if each deduction was considered separately. The standard deduction would absorb part of the cost that would